Unique Accounting & Tax Strategies Pty Ltd ABN: 28158350479
Unique Financial Planning Strategies Pty Ltd ABN: 79158423155
Unique Loan Strategies Pty Ltd ABN: 30158423324
Unique Investment Property Strategies Pty Ltd ABN: 23158423735

PO Box 597
Mornington VIC 3931

P: 1300-946-249
F: (03) 8738-1520
www.uniquestrategies.com.au
admin@uniquestrategies.com.au

Maximise Interest Deduction When Upgrading Home

Often when people purchase a new home they wish to retain their current home and convert it to an investment property. This avoids having to pay stamp duty and real estate agent fees on an alternative investment property. When the old home is made available for rental, tax deductions can be claimed for interest expenses incurred on the original mortgage. The problem arises where there is little or no debt outstanding on the old home, but they must borrow to acquire their new home. As the borrowed funds are used to acquire a private asset, even if secured over the old home, the interest expenses incurred will not be deductible under the Income Tax Act.

To avoid this, an alternative is for one spouse to purchase the other spouse's share of the home. Generally, the higher income earning spouse could borrow the funds to buy the lower income earning spouse's portion of the current family home. A written real estate valuation of the property will need to be obtained and 50% of the valuation is the amount which the higher income earning spouse will pay the lower income earning spouse for the half share. This full amount can be borrowed and the interest claimed as a tax deduction.

The funds received by the lower income earning spouse are then used to purchase their share of the new family home and therefore lower the level of private debt. Further benefits are obtained as there is no stamp duty charged for transfers between spouses and no capital gains tax applies for the disposing spouse as the home was used as their principal residence.

When the home is eventually sold, all the capital gains will be attributed to the higher income earning spouse. An apportionment of the gain will be made, to exempt the portion that the home was used as the family home under the principal residence exemption. The capital gain is calculated as the excess of the sale proceeds over the cost base. The cost base is calculated as 50% of the original purchase price plus the amount paid for the spouse's share.

For example, assume John and Jane own their family home valued at $400,000 jointly and have a mortgage of $100,000. They bought the property for $300,000.

John and Jane decide to retain the current property and rent it out. The new home will cost $500,000. Jane can sell her 50% portion of the current home to John for $200,000 and John can borrow this amount from the bank in order to pay Jane. The investment property (current home) then has $250,000 debt associated with it (i.e. $200,000 plus John's share of the $100,000 remaining mortgage).

The interest on the $250,000 borrowing will be deductible to John while the property is rented or available to rent. John and Jane can then purchase their new home with the $200,000 John paid Jane for her share of the investment property less the $50,000 of Jane's share of the debt on the investment property, in addition to $300,000 additional borrowing. Note the interest on the $350,000 is not tax deductible.

	Option #1	**Option #2**
	Held Jointly	
Investment property debt	$100,000	$250,000
New family home debt	$500,000	$350,000
Total debt	**$600,000**	**$600,000**

In this example, the cost base of the property to John will be 50% of the original purchase price $150,000 plus $200,000 = $350,000.

Where a transaction creates a tax benefit to a taxpayer, in particular where related taxpayers transact with one another, we must consider the impact of Part IV A being applied by the Australian Taxation Office (ATO). A tax benefit has been obtained through the tax deduction for the interest on the loan. The ATO will generally look to apply the provisions when they consider the tax benefit was the dominant purpose for entering into the transaction. Where they consider the dominant purpose is the tax benefit they can cancel the benefit and deny any tax deductions.

To counter the argument you need to show that there were other more influential reasons for the transaction such as the intention to create a portfolio of investment properties to help fund for your retirement. Also that a tax deduction would have been available if the old home was sold and a new one purchased but that this particular process was undertaken to avoid the estate agent fees and stamp duty charges.